Regular article

Short selling around the 52-week and historical highs

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\begin{abstract}
Although the distance of a stock price to its past price high does not provide fundamental-related information, it plays an important role of anchoring investors' expectations about the performance of stocks. Using a stock's 52-week and historical highs, we examine the impact of the nearness to these price highs on short sellers' trading behavior in the U.S. equity market from 1988 to 2012. We find that short selling is negatively associated with the nearness of the price to the 52-week high, while it is positively associated with the nearness to the historical high. This suggests that short sellers exploit other investors' behavioral biases.
\end{abstract}

\section{1. Introduction}

Market anomalies have been the focus of an extensive literature in financial economics.\textsuperscript{1} Following this literature, some recent studies provide evidence on how sophisticated investors trade on these anomalies, although the results are mixed.\textsuperscript{2} Yet, few researchers have attempted to specifically examine how short

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\textsuperscript{2} For instance, Core et al. (2006) find that insiders tend to exploit the accrual anomaly, while Edelen et al. (2016) show that institutional investors contribute to mispricing by buying overvalued stocks and selling undervalued stocks.

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sellers exploit some of these anomalies.\(^3\) We contribute to this line of research by studying how short sellers exploit behavioral biases of other traders through the analysis of their trading activities based on a stock’s past price highs.

A record-high stock price, such as a monthly high or a 52-week high, has become an important factor that affects the behavior of market participants and corporate managers. Prior studies document that the price high affects not only investors’ trading behavior (Grinblatt and Keloharju, 2001; George and Hwang, 2004; Huddart et al., 2009; Li and Yu, 2012) but also managers’ decision making, such as stock option exercise (Heath et al., 1999; Poteshman and Serbin, 2003) and mergers and acquisitions (Baker et al., 2012). These studies suggest an explanation based on psychological heuristics, such as an adjustment and anchoring bias (Tversky and Kahneman, 1974) and prospect theory (Kahneman and Tversky, 1979). Given that such behavioral biases cause mispricing, such as momentum and reversals in stock returns, trading strategies that exploit these biases can generate trading profits.

In this study, we focus on the effect of two different price highs on short sellers’ behavior: the 52-week high and the historical high, which are publicly available through the financial media.\(^4\) Comparing a stock’s current price with its past price highs should not provide information about fundamental changes. Nonetheless, market participants often debate whether a stock’s price high should be considered as a price resistance level or a starting point for a price rally.\(^5\) Prior literature finds that these two price highs are used as anchors when investors evaluate information.\(^6\) In the case of the 52-week high, investors tend to underreact to good news when the current price is near the 52-week high and overreact to bad news when the stock price is far from its 52-week high (George and Hwang, 2004). On the other hand, the anchoring behavior based on the historical high is found to be the opposite: investors tend to overreact to good news when the stock price is close to its historical high and underreact to bad news when the price is far from the historical high (Li and Yu, 2012).

Taken together, the nearness of a stock price to its 52-week and historical highs indicates not only the relative levels of current prices but also the presence of investors’ anchoring bias. This raises the question of how this price information influences the trading behavior of informed traders. Intuitively, informed traders should be able to exploit other investors’ behavioral biases based on the nearness to the 52-week and historical highs. However, we cannot rule out the possibility that even informed traders are also subject to behavioral biases.

Motivated by this, we examine how short sellers react to the nearness of a stock price to the 52-week and historical highs. We propose three alternative hypotheses. Our first hypothesis, the behavioral exploitation hypothesis, is based on the previous finding that short sellers are informed. If short sellers are sophisticated enough to identify investors’ anchoring biases associated with the 52-week and historical highs, they will trade on underreaction to bad news when the price is far from the 52-week high and overreaction to good news when the price is close to the historical high. For our second hypothesis, the contrarian short-selling hypothesis, we conjecture that short-selling activities simply depend on a stock’s price level relative to its past price highs. Therefore, when the recent price is close to the 52-week or historical high, short sellers will increase their trading in anticipation of price reversals. Alternatively, in the third hypothesis, the biased short-selling hypothesis, we allow for the possibility that short sellers are subject to anchoring biases based on the 52-week and historical highs. In this case, they will underreact based on the nearness to the 52-week high and overreact based on the nearness to the historical high.\(^7\)

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\(^3\) Hwang and Liu (2012) find the trading behavior of short arbitrageurs based on several return anomalies, while Israel and Moskowitz (2013) find no evidence that momentum and value profits mainly come from shorting.

\(^4\) While the 52-week high is the readily available information released through the media, the historical high can be obtained from financial articles or historical prices data provided by the financial websites such as YAHOO! Finance.

\(^5\) See, for example, “With stocks so high, should investors move to cash?” (http://www.wsj.com/articles/with-stocks-so-high-should-investors-move-to-cash-1404679639) or “Buying stocks at record highs: Will you be sorry?” (http://blogs.wsj.com/moneybeat/2013/11/22/buying-stocks-at-record-highs-will-you-be-sorry/).

\(^6\) This is somewhat in line with Kahneman and Tversky (1973) and Tversky and Kahneman (1971), who argue that investors expect trends to continue or to be reversed on a case-by-case basis.

\(^7\) Anecdotal evidence suggests that informed traders trade on the distance of the stock price to its past price highs. For example, when the stock price of TJX Cos. approached its 52-week high in September 2006, seven insiders at its holding
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